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AIRPORT COMMISSION:

Concession Audit of DFS Group, L.P.

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City and County of San Francisco

Office of the Controller – City Services Auditor

AIRPORT COMMISSION:

**Concession Audit of DFS Group,
L.P.**

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October 26, 2009

**CONTROLLER'S OFFICE
CITY SERVICES AUDITOR**

The City Services Auditor was created within the Controller's Office through an amendment to the City Charter that was approved by voters in November 2003. Under Appendix F to the City Charter, the City Services Auditor has broad authority for:

- Reporting on the level and effectiveness of San Francisco's public services and benchmarking the city to other public agencies and jurisdictions.
- Conducting financial and performance audits of city departments, contractors, and functions to assess efficiency and effectiveness of processes and services.
- Operating a whistleblower hotline and website and investigating reports of waste, fraud, and abuse of city resources.
- Ensuring the financial integrity and improving the overall performance and efficiency of city government.

The audits unit conducts financial audits, attestation engagements, and performance audits. Financial audits address the financial integrity of both city departments and contractors and provide reasonable assurance about whether financial statements are presented fairly in all material aspects in conformity with generally accepted accounting principles. Attestation engagements examine, review, or perform procedures on a broad range of subjects such as internal controls; compliance with requirements of specified laws, regulations, rules, contracts, or grants; and the reliability of performance measures. Performance audits focus primarily on assessment of city services and processes, providing recommendations to improve department operations.

We conduct our audits in accordance with the Government Auditing Standards published by the U.S. Government Accountability Office (GAO). These standards require:

- Independence of audit staff and the audit organization.
- Objectivity of the auditors performing the work.
- Competent staff, including continuing professional education.
- Quality control procedures to provide reasonable assurance of compliance with the auditing standards.

Audit Team: Helen Storrs, Audit Manager
Annie Cheng, Associate Auditor
Helen Vo, Associate Auditor



CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

October 26, 2009

San Francisco Airport Commission
P.O. Box 8097
San Francisco International Airport
San Francisco, CA 94128

President and Members:

The Controller's Office, City Services Auditor, presents its report concerning the audit of DFS Group, L.P. (DFS). DFS has a 10-year agreement, through December 9, 2010, with the Airport Commission of the City and County of San Francisco to operate retail shops at the San Francisco International Airport (SFO).

Reporting Period: January 1, 2005, through December 31, 2007

Fees Paid: \$74,270,425

Results:

Although DFS reported gross revenue of \$226,910,431 that are considered materially complete, the audit team noted slight differences in revenues reflected in DFS internal reports and sales tax returns when compared to revenues reported to the Airport. In addition, Sephora, a brand under DFS, was unable to provide support for reported 2005 revenues for two facilities.

DFS substantially complied with the reporting and payment provisions of the lease agreement. The audit team did note that DFS did not always submit timely rent payments and monthly statements with the required certification signature.

The responses from the Airport and DFS are attached to this report. The Controller's Office, City Services Auditor, will work with the Airport to follow up on the status of the recommendations made in this report.

Respectfully submitted,

Robert Tarsia
Deputy Audit Director

cc: Mayor
Board of Supervisors
Budget Analyst
Civil Grand Jury
Public Library

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INTRODUCTION

Audit Authority

The Office of the Controller (Controller) has authority under the San Francisco Administrative Code, Chapter 10, Article 1, Section 10.6-2 to audit, at regular intervals, all leases of city-owned real property where rent of \$100,000 or more a year is to be paid to the City and County of San Francisco (City). In addition, the City Charter provides the Controller, City Services Auditor (CSA), with broad authority to conduct audits. We conducted this audit under that authority and pursuant to an audit plan agreed to by the Controller and the Airport.

Background

DFS Group, L.P. (DFS) has a 10-year lease agreement with the City's Airport Commission (Airport), expiring on December 9, 2010, to operate 34 retail facilities at San Francisco International Airport (SFO). This included 15 facilities owned by DFS, 15 subleased facilities, and two facilities operated by Sephora, a brand owned by DFS' parent company, the Moët Hennessy Louis Vuitton (LVMH) group.¹ DFS is permitted to operate retail facilities that offer duty free and duty paid merchandise.

The lease agreement requires DFS to pay the Airport Department (Airport) the greater of a minimum annual guarantee (MAG) or a tiered percentage rent of its annual gross revenues. The amount of percentage rent depends on whether the retail facility is duty free, duty paid, or an additional facility.² Tiered percentage rent for duty free facilities ranged from 20 to 40 percent, while duty paid and additional facilities ranged from 12 to 16 percent during the audit period. The Airport has the authority to adjust the MAG annually.

Scope and Methodology

The purpose of this audit was to determine if DFS:

- Complied with the reporting and payment provisions of its lease agreement.
- Complied with other provisions of its lease agreement

¹ Although DFS was authorized in the lease to operate 34 facilities, only 32 were operational during the audit period.

² An additional facility is a sub-leased premise subject to the minimum annual guarantee and percentage rent as stated in the respective agreement.

with the Commission.

The audit covered the period January 1, 2005, through December 31, 2007.

To conduct the audit, the audit team:

- Examined the applicable terms of DFS' lease agreement.
- Assessed the adequacy of its procedures for collecting, recording, summarizing, and reporting its gross revenues to the Airport.

To determine whether DFS accurately reported its gross revenues to the Airport, the audit team:

- Tested, on a sample basis, DFS' monthly sales records and daily sales reports.
- Determined whether DFS had any outstanding payments for the period.
- Compared the gross revenues reported to the Airport with the gross revenue reported to the California State Board of Equalization for the audit period.
- Verified DFS' compliance with certain other provisions of its lease.

This performance audit was conducted in accordance with generally accepted government auditing standards. Those standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

AUDIT RESULTS

DFS Properly Reported Its Gross Revenues

DFS reported gross revenues of \$226,910,431 and paid \$74,270,425 in rent to the Airport from January 1, 2005, through December 31, 2007. Exhibit 1 summarizes DFS' reported gross revenues and rent paid under its lease agreement.

EXHIBIT 1 Gross Revenues Reported and Rent Paid January 1, 2005, Through December 31, 2007

	January 1, 2005, Through December 31, 2005	January 1, 2006, Through December 31, 2006	January 1, 2007, Through December 31, 2007	Totals
Gross Revenues Reported				
Duty Free	\$ 48,213,552	\$ 49,697,240	\$ 59,030,320	\$156,941,112
Duty Paid ³	18,196,792	21,999,043	25,845,917	66,041,752
Additional Facilities	<u>1,346,800</u>	<u>1,353,584</u>	<u>1,227,183</u>	<u>3,927,567</u>
Total Gross Revenues	\$ 67,757,144	\$ 73,049,867	\$ 86,103,420	\$226,910,431
Total Rent Paid	\$ 21,895,425	\$ 26,100,000	\$ 26,275,000	\$ 74,270,425

Source: DFS Group's Monthly Statements of Sales and Rent Due.

DFS' Internal Reports Do Not Support Reported Revenues

Although DFS materially reported its gross revenues correctly, DFS monthly and daily revenue reports contained differences when compared to revenues reported to the Airport. DFS staff located in the United States and its accounting staff in Singapore provided separate revenue reports, each containing different amounts than the revenues reported to the Airport.

For the three sample months reviewed, the revenue reports provided by the Singapore and United States offices were understated by \$278,942 and \$247,935, respectively. According to DFS Singapore staff, revenue reports were provided from two separate systems: the stock system that records sales, and the collection system that records cash

³ Subtenant revenues are included in the duty paid revenues.

and credit card collections daily. Differences could be due to cash overages or shortages eventually resolved and updated in the firm's cash reconciliation system. DFS Singapore staff did not provide detailed explanations of differences noted for the sample months. Under its lease agreement, DFS is required to maintain accurate accounting records that support revenues reported to the Airport.

Exhibit 2 summarizes the differences in reported revenues.

EXHIBIT 2 Differences in DFS Revenue Reports

Revenues	Sept. 2005	Mar. 2006	Nov. 2007	Totals
DFS Singapore Report	\$ 4,808,305	\$ 4,611,399	\$ 6,299,495	\$ 15,719,199
Concession Reports Sent to Airport	4,868,914	4,658,789	6,470,438	15,998,141
DFS United States Report	4,826,775	4,623,183	6,300,248	15,750,206
Difference between Singapore Report & Concession Report				\$ 278,942
Difference between US Report and Concession Report				\$ 247,935

Sources: DFS – SFO Sales by Location & Transaction Report, Total Net Sales by DFS, Monthly Concession Report.

DFS Did Not Have a Lease Agreement With Sub-Tenant, U-Threads

During the audit period, U-Threads, which sells collegiate apparel and related gifts and souvenirs, operated a retail facility at the Airport, as a sub-tenant of DFS. DFS and U-Threads did not have a formal written lease agreement approved by the Airport. According to the Airport's property manager, DFS and U-Threads had a month-to-month verbal agreement that never transitioned into a formal contract. According to DFS' lease agreement with the Airport, DFS must obtain the Airport's approval for all sub-lease agreements. Upon the Airport's approval, DFS is required to use diligent, good faith efforts to negotiate a sub-lease agreement. Further, sub-lease agreements must be in the form of the Airport's standard sublease agreement.

U-Threads was a sub-tenant with DFS at the start of the audit period in January 2005, and its sub-tenancy ended in February 2009, which clearly did not meet the sub-leasing requirements in DFS' lease with the Airport.

**Sephora Did Not Provide
Supporting Documents
for 2005**

For 2005, the audit team could not verify revenues reported by Sephora because it did not provide any monthly or daily supporting documents to DFS. Sephora is not a sub-tenant of DFS, but is a brand under the DFS parent company. DFS' lease agreement, which requires maintaining separate and accurate daily records of gross revenues for a period of five years after the lease expiration date, applies to Sephora. According to Sephora's accounts payable and sales audit manager, the systems data for 2005 has been purged and a system back-up file cannot be located. Therefore, Sephora cannot provide the required supporting documentation for the reported revenues.

**DFS' Reported Revenues
Did Not Agree With
Revenues Reported on
Its State Sales Tax
Returns**

Revenues reported by DFS to the Airport did not agree with revenues reported on DFS' state sales tax returns for two of the three quarters reviewed in 2006 and 2007. For the first quarter of 2006, revenues reported to the Airport exceeded revenues on the sales tax returns by \$120,609, or 5.6 percent. For the fourth quarter of 2007, revenues reported to the Airport exceeded sales tax returns by \$876,088, or 31.4 percent. According to DFS Singapore staff, the variances between the revenues reported to the Airport and revenues on the sales tax returns are due to various travel agent discounts, employee discounts, and packed foods amounts. After extensive review of documents provided by DFS, the audit team was not able to reconcile the differences in revenues. Moreover, DFS did not provide the audit team with a satisfactory reconciliation of the differences.

**DFS Did Not Always
Submit Rent On A Timely
Basis**

DFS did not submit all of the rent payments during the audit period on a timely basis, as required by its lease agreement. The lease agreement requires DFS to pay the monthly MAG on or before the first of each month. DFS then calculates the percentage rent on the gross revenues earned for the month, and if the percentage rent exceeds the monthly MAG, DFS is required to pay the additional rent on or before the 20th of the following month. Any rent not paid when due is subject to a service charge of 1.5 percent per month. The audit team did not calculate late fees since all late payments occurred in 2005 and the late fee amounts would be insignificant. However, the Airport should ensure that all rent is collected on time.

**DFS Did Not Always
Timely Submit Signed
Monthly Statements**

For 7 of the 36 months of the audit period, DFS did not submit signed monthly statements certifying the sales report as being true and correct. In addition, DFS submitted monthly statements one to eight days late for 9 of the 36 months. The lease agreement requires DFS to submit monthly reports to the Airport, on or before the 20th day of each calendar month, showing all gross revenues achieved the prior month, and required that the statements be certified by DFS as being true and correct. DFS should ensure that monthly statements are submitted in compliance with the all lease agreement terms.

**DFS Lacked Controls
Over Manual Sales
Tickets and Logs**

During the audit team's visit to a DFS retail facility at the Airport, DFS' general manager and administrative manager could not locate the manual sales tickets or logs used when the Point-of-Sale (POS) system is unoperational. According to DFS' general manager, manual sales tickets and logs are secured in a locked cabinet. On the day of the visit, the tickets and logs could not be found. The DFS general manager and administrative manager indicated that the tickets and logs were recently used at one of the retail facilities. DFS should ensure that established procedures are in place to secure the manual sales tickets and log at all times.

**Airport Invoices Were
Incorrect**

The audit team found numerous instances in which the Airport's invoice amount or percentage rates did not agree with DFS' monthly reports or the approved percentage rates. According to Airport accounting staff, these errors did not affect the amount due to the Airport because DFS either paid the MAG or less.⁴ Therefore, these incorrect invoices were not sent to DFS. Although the errors on the invoices did not affect payments to the Airport, accurate invoices should be prepared and maintained by the Airport and DFS.

**Airport Incorrectly Coded
Storage Rental Fees**

From January 2007 through May 2007, the Airport incorrectly coded storage rental fees from DFS, totaling \$58,733, under the concession fee category. Airport staff indicated that this was an unintentional error. Since the error occurred in 2007, adjusting entries are not possible. The Airport should take more care in posting payments to the correct revenue code.

⁴ Per amendment 5 of the lease agreement, for the 2005 year only, base rent for duty free facilities was limited to 40 percent of 2005 duty free gross revenues.

Recommendations

The Airport Department should ensure that DFS:

1. Maintain reconciliations between the revenues reported to the Airport and DFS systems data.
2. Has signed, formal written agreements for all sub-tenants.
3. Complies with lease agreement terms regarding record retention and takes more care in maintaining systems data.
4. Maintain reconciliations between revenues reported to the Airport and taxable revenues reported to the California State Board of Equalization.
5. Pay its rent timely.
6. Submits signed and certified monthly statements, as required by its lease.
7. Has procedures in place to secure manual sales tickets and log.

The Airport Department should also ensure that:

8. All invoices are accurate.
9. Payments are posted to the correct revenue category.

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ATTACHMENT A: AIRPORT'S RESPONSE



San Francisco International Airport

October 6, 2009

VIA EMAIL

Mr. Robert Tarsia
Deputy Audit Director
Office of the Controller
City and County of San Francisco
City Hall, Room 476
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

PO Box 2097
San Francisco, CA 94128
Tel: 415 821 5000
Fax: 415 821 5005
www.sfo.com

Reference: The Post-Security Master Retail/Duty Free Concession Lease No. 99-0035 between the City and County of San Francisco, through its Airport Commission, and DFS North America, A Division of DFS Group L.P.

Dear Mr. Tarsia:

The San Francisco International Airport ("Airport") is in receipt of the Audit Recommendation from City Services Auditor Division for its audit of the Post-Security Master Retail/Duty Free Concession Lease No. 99-0035 between the City and County of San Francisco, through its Airport Commission, and DFS North America, A Division of DFS Group L.P. ("Tenant").

The Airport will draft letter to tenant outlining audit findings and reiterate importance of maintaining provisions of the Lease under penalty of fines. The following is the Airport's response to the Audit Report findings:

1. **Maintain reconciliations between the revenues reported to the Airport and DFS' systems data.** The Airport agrees with this statement.
2. **Has signed, formal written agreements for all sub-tenants.** The Airport agrees with this statement.
3. **Complies with lease agreement terms regarding record retention and takes more care in maintaining systems data.** The Airport agrees with this statement.
4. **Maintain reconciliations between revenues reported to the Airport and taxable revenues reported to the California State Board of Equalization.** The Airport agrees with this statement.
5. **Pay its rent timely.** The Airport agrees with this statement.
6. **Submits signed and certified monthly statements, as required by its lease.** The Airport agrees with this statement.
7. **Has procedures in place to secure manual sales tickets and log.** The Airport agrees with this statement.
8. **All invoices are accurate.** The Airport agrees with this statement. Revenue Development and Management will work with accounting to insure proper billing on invoices.
9. **Payments are posted to the correct revenue category.** The Airport agrees with this statement. Accounting will work to insure proper billing on invoices.

AIRPORT
COMMISSION
CITY AND COUNTY
OF SAN FRANCISCO
GAVIN NEWSOM
MAYOR
LAURE MARELLA
PRESIDENT
LINDA S. CRAYTON
VICE PRESIDENT
CAROL LEO
ELIZABETH JOHNS
RICHARD J. GILGENSEN
JOHN L. MARTIN
AIRPORT DIRECTOR

Mr. Robert Tarsia
Deputy Audit Director
Page 2
October 6, 2009

Thank you for your staff's work on this audit. Please do not hesitate to call at 650.821.4500 if you have any questions.

Sincerely,



Cheryl Nashir
Associate Deputy Airport Director
Revenue Development and Management

Attachment

cc: Wallace Tang
Helen Storrs (Helen.Storrs@sfgov.org)
John Reeb

Recommendation	Responsible Agency	Response
The Airport Department should ensure that DFS:		
1. Maintain reconciliations between the revenues reported to the Airport and DFS' systems data.	Airport	Airport agrees. The Airport will draft letter to tenant outlining audit findings and reiterate importance of maintaining provisions of the Lease under penalty of fines.
2. Has signed, formal written agreements for all sub-tenants.	Airport	Airport agrees.
3. Complies with lease agreement terms regarding record retention and takes more care in maintaining systems data.	Airport	Airport agrees.
4. Maintain reconciliations between revenues reported to the Airport and taxable revenues reported to the California State Board of Equalization.	Airport	Airport agrees.
5. Pay its rent timely.	Airport	Airport agrees.
6. Submits signed and certified monthly statements, as required by its lease.	Airport	Airport agrees.
7. Has procedures in place to secure manual sales tickets and log.	Airport	Airport agrees.
The Airport Department should also ensure that:		
8. All invoices are accurate.	Airport	Airport agrees.

Recommendation	Responsible Agency	Response
9. Payments are posted to the correct revenue category.	Airport	Airport agrees.

ATTACHMENT B: DFS' RESPONSE



October 8, 2009

Ms. Helen Storrs
Audit Manager
Office of the Controller
City Services Auditor Division
City & County of San Francisco
City Hall, Room 316
One Carlton B. Goodlett Place
San Francisco, CA 94102

RE: DFS Group L.P. – Audit Findings Response

Dear Ms. Storrs:

In follow-up to our telephone conversation, please find below our responses to your reported findings resulting from the above referenced audit:

1. **Finding:** DFS' monthly and daily reports do not support revenues reported to the airport.

Response: DFS does not agree with this finding and believes that the most updated file was not used to perform this analysis. We have attached herewith the reconciliation schedule that was submitted in support of the audit work and would request that the auditor re-review this file and identify the referenced discrepancies.

2. **Finding:** Sephora did not provide supporting documents for 2005

Response: DFS agrees with this finding. DFS will remind Sephora of its obligation to have required documentation available to provide in the future.

3. **Finding:** DFS' reported revenues did not agree with revenues reported on its California sales tax returns

Response: DFS does not agree with this finding, as our review of our reported revenues and California sales tax returns for the period in question do agree. We believe that the auditor did not reference the correct information when making this determination and have attached herewith the reconciliation of State sales tax returns that was submitted in support of the audit work. We would

DFS North America
A Division of DFS Group L.P. 1580 Francisco Street
Torrance, California 90501
Telephone (310) 783-6600
Facsimile (310) 783-6601



request that this information be re-reviewed and that the auditor identify the discrepancies referenced by this finding.

4. Finding: DFS did not always submit rent on a timely basis

Response: DFS does not agree with this finding. The monthly allocation of the Minimum Annual Guaranteed ("MAG") Rent as applicable under the Master Lease is automatically paid by DFS via wire transfer on the first of each month. We would request that the auditor identify the months for which DFS is being cited for making late payments.

However, if this finding references a failure to pay monthly Percentage Rent, we should note that during 2005 the percentage rent payable in certain months did exceed the monthly MAG allocation payments made by DFS. However, on a year-to-date basis during 2005 the accumulated rent payments remained within our MAG obligation which is why DFS made no additional monthly percentage rent payments. DFS was subsequently advised by airport staff that even if the rent payable remains within the MAG on a year-to-date basis, monthly percentage rent payments must still be made in any month where the percentage rent due within that month exceeds the monthly allocated MAG payment – and may be reclaimed as an over-payment when the rent payable for the full 12-month period has been reconciled with the individual monthly MAG and percentage rent payments made through that annual period. We have adhered to this requirement since 2006.

5. Finding: DFS did not always submit signed monthly statements timely

Response: DFS does not agree with this finding. To the best of our knowledge, all monthly statements have been signed and submitted by the 20th of each month as required. We request that the auditor identify the months for which DFS is being cited for the submission of signed/late monthly statements.

6. Finding: Manual sales tickets and logs were not maintained in a secure location by DFS' airport operations staff

Response: DFS does not agree with this finding. Following our review of this finding with our airport operations staff, we have determined that the field auditor was advised that the manual log was being maintained in our Terminal 1 facility, as that was the location in which the automated Point of Sale ("POS") equipment was not working at the time of the audit. The manual log is only used when the automated POS system is off-line – which is a rarity. Once the POS equipment in Terminal 1 was brought on-line the log was returned to the main store office, which is where it remains unless required elsewhere.

Ms. Helen Storrs
October 8, 2009
Page 3 of 3



7. Finding: DFS did not have a sublease agreement with subtenant U-Threads

Response: DFS agrees with this finding and acknowledges that U-Threads operated under a simple letter agreement and that a formalized sublease was never entered into with U-Threads. Going forward, DFS will not permit the commencement of any third-party retail operations under our Master Lease before a sublease agreement covering those operations has been fully executed.

We appreciate the effort of the City Services Auditor Division in completing this audit work and would be happy to discuss the audit findings further and/or once again review the selected finding above where we have requested additional information or a re-review of the initial results. Please feel free to contact me directly if there are any further questions. (310-783-6681)

Sincerely,

DFS Group L.P.

A handwritten signature in cursive script, appearing to read "Nicole Malozi".

Nicole Malozi
Operations & Control Director – NAM

cc: Joe Camacho, DFS

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ATTACHMENT C: REBUTTAL TO RESPONSE

To provide clarity and perspective, the Controller's Office, City Services Auditor Division, is commenting on the response to our audit report from the DFS Group, L.P. The findings listed below correspond to the format provided in the DFS Group, L.P. response.

1. Finding: DFS' monthly and daily reports do not support revenues reported to the Airport.

Additional information submitted by DFS Group did not answer the auditors' questions. DFS Group should consult with the Airport Property Manager if assistance is needed to ensure reconciliations are maintained to support revenues reported to the Airport.

3. Finding: DFS' reported revenues did not agree with revenues reported on its California sales tax returns.

Additional information submitted by DFS Group did not answer the auditors' questions. DFS Group should consult with the Airport Property Manager if assistance is needed to ensure reconciliations are maintained between revenues reported to the Airport and taxable revenues reported to the California State Board of Equalization.

4. Finding: DFS does not always submit rent on a timely basis.

The audit team provided a listing to DFS Group of the late payment months noted in the audit report. DFS Group should consult with the Airport Property Manager if it needs clarification of the payment provisions specified in Section 4.3 of the lease agreement.

5. Finding: DFS did not always submit signed monthly statements timely.

The audit team provided a listing to DFS Group of the months noted in the audit report. DFS Group should consult with the Airport Property Manager if it needs clarification of the reporting provisions specified in Section 4.3 of the lease agreement.

6. Finding: Manual sales tickets and logs were not maintained in a secure location by DFS airport operations staff.

The audit team recognizes the manual log is only used when the automated system is off-line and the log and tickets are maintained in the main store office when the automated system is functional. DFS Group should consult with the Airport Property Manager if it needs clarification of recommended practices in this area.

